

Intangible Drilling Costs (IDC) and Other Deductions
Drive Innovation and Job Creation
Position Paper
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Background: Congress and the Obama Administration are considering the repeal of a 99 year-old tax provision for Intangible Drilling Costs (IDC), and other tax provisions. These routine tax deductions, intended to ensure robust domestic oil and natural gas production, are often mischaracterized as subsidies or loopholes, yet are actually deductions for business expenses, which every other business in America is allowed to take.

Every small business whether a family farm, tool factory, or automobile parts supplier deducts the costs associated with the research, development, and production of its goods and services. For the oil and natural gas industry, our “factory” is miles underground, but it’s at least as modern as any other factory, and more high-tech than most.

Every year, we build tens of thousands of “factories,” each of which costs generally from \$4 million to \$10 million. While the footprint of our factories may only be a few hundred feet across on the surface, there are millions of dollars of intangible costs associated with building them. Seismic work, roads, site preparation, environmental mitigation, labor costs – these are intangible drilling costs. They’re intangible because there is no residual value for a hole in the ground once the well has finished producing. An above-ground factory has substantial remaining value in its machinery, bricks and mortar, and other equipment.

Expensing IDCs for tax purposes provides a self-financed line of credit by which companies recover the initial investment of each well and quickly turn that capital around and reinvest it into the next well – the next “factory.” IDC expensing provides the flow-through capital to thousands of independent producers who in turn drive innovation and new development, a prime example being horizontal drilling and advances in hydraulic fracture stimulation.

IDC deductions constitute the R&D program for the oil and natural gas industry. Unlike other R&D programs funded by government subsidies and taxpayer handouts, IDCs are a vast, private-sector funded R&D program that far outstrips anything the federal government could conceive or provide.

Shale, tight sands, and other unconventional plays from North Dakota to Colorado to Texas were made economically feasible by IDC tax provisions helping to recover the costs of development. Without IDCs, these promising new resources likely would not have been developed, and huge domestic energy supplies would remain untapped. Continued reinvestment of capital enables new technologies such as 4-D seismic visualization, laser drilling, “walking” rigs, advanced water recycling, and improved safety.

Oil and natural gas exploration is a risky business with no guarantee of success. When a well is drilled, 60-80% of the costs accrue regardless if a well produces or is a dry hole. Because unconventional natural gas plays have higher rates of decline than traditional wells, more wells must be drilled each year to keep up with demand. Western Energy Alliance members rely on IDC tax provisions to fund exploration and production of safe, clean and domestic energy while creating jobs and spurring economic growth.

Impact of Repealing IDCs: IDC repeal would have a devastating impact on the independents who drill 90% of all new wells in the U.S., most of which are small businesses.

- Thousands of small producers in particular rely almost exclusively on IDC tax provisions to provide the working capital for their day-to-day operations. Repeal of IDC expensing would discourage the risk-taking, investment and development of new wells.
- Some suggest that repealing IDCs and replacing them with lower corporate taxes may be a good compromise. However, the vast majority of producers are small companies organized as partnerships or other non-corporate structures. Exchanging repeal of IDCs with a lower corporate tax rate would leave them without a means to deduct their business expenses, further disadvantaging them to large corporations.
- Repealing IDCs would result in less American production, fewer jobs, and in turn less sales tax, ad valorem, and severance tax revenue for states. These revenues are critical for funding education, infrastructure, emergency services, and other vital state and local services.
- Without IDC deductions independents would be the only small businesses with no provisions in the tax code to allow them to offset the cost of doing business in America. Contrast that with a wind turbine produced overseas that would be 100% deductible while also enjoying a direct subsidy. That is not equitable and contrary to basic tax principles.
- Industry pays \$86 million a day to the federal government. The federal treasury would see a decline in oil and natural gas production and revenues should IDCs be repealed.

Other Tax Provisions: IDCs, percentage depletion and G&G deductions reduce production costs, and effectively increase investments in locating and exploring for new reserves in America, rather than sending those investments abroad. The President's budgets for the last several years have also proposed repealing them.

- **Percentage depletion** is an income tax treatment whereby natural resource minerals are eligible for a deduction to account for the fact that they deplete over time. Depletion is the using up of natural resources by mining, quarrying, drilling, or felling. The depletion deduction allows an owner or operator to account for the reduction of a product's reserves. The allowable percentage for oil and natural gas is 15%.

Percentage depletion for oil and natural gas is only available to independent producers and royalty owners as a way to encourage the participation of small businesses. The deduction has been part of the tax code since 1926, and is only available on the first thousand barrels of oil equivalent per day. It enables producers to recover the investments they've made and generate additional capital for further exploration and production. By allowing for the recovery of capital investment over time, it is essential for meeting the costs of operating marginal wells.

- **Geological and Geophysical (G&G)** expenses include the costs for geologists, seismic surveys, and the drilling of core holes. G&G cost treatment was changed in the Energy Policy Act of 2005 to allow for faster recovery of costs to encourage domestic exploration and production. These costs are similar to R&D costs, which other industries not only deduct but may also receive tax credits. Extending the amortization period would remove over \$1 billion from efforts to find and develop new American production.